ANALYST INTERVIEW

RANDY BINNER — FBR CAPITAL MARKETS & CO.

Positive Pricing Trends for P&C and a Rotation Back Into Life Insurance

RANDY BINNER is a Managing Director covering the life and property/casualty insurance sectors at FBR Capital Markets & Co. Mr. Binner joined the company’s insurance team in 2004 as a Research Associate before his promotion to Analyst in 2007 and to Senior Analyst in 2010. In these roles, he has covered life, property/casualty and insurance brokerage companies. He also has two years of industry experience at Travelers, where he managed environmental and asbestos liability claims. In 2011, Mr. Binner was ranked number one in the insurance sector for stock picking by StarMine. In 2009, he was ranked the number two earnings estimator in the insurance sector by Financial Times/StarMine. He was also recognized in The Wall Street Journal’s “Best on the Street” awards, ranking number four for stock picking in the life insurance industry in 2009. Mr. Binner received his MBA in finance from George Washington University and his B.A. in history from Colorado College.

SECTOR — INSURANCE

(AEK800) TWST: What market trends are you observing in retirement products? And what are the implications of those trends for the companies in your group?

Mr. Binner: The main retirement product that the life and annuity industry sells are annuities. This group also participates in the standard part of the retirement market that asset managers do mostly through 401(k) and other retirement plans, but those businesses are asset management businesses that generally carry a certain multiple and probably aren’t a type of insurance like annuities. And so, the trends are that there is a lot of demand for the product. Sales of variable annuities and traditional fixed annuities have moderated as the companies have pressure from low interest rates, but indexed annuities, which is about 15% of the annuity market, are actually growing still, and so that’s been an area where insurance companies feel that they can safely gather Baby Boomer assets.

TWST: What trends are you observing with regard to the transition from a soft to hard P&C pricing market?

Mr. Binner: Life and annuity providers are retrenching somewhat because of the pressure of the low interest rate environment. Property casualty insurers are seeing a better, harder pricing environment. And this is a function of exactly what you said, that the market for insurance products, the pricing, was soft pretty much from toward 2004 until around 2008 or 2009. And so, what happens when you underprice those policies is that loss costs eventually start to rise, and now in 2013, we are at a point where prices are increasing not only to deal with higher loss trends, but also they are to offset some of the interest rate pressure. All insurance companies make a good portion of their money from net investment income. And so, the bottom line is we’re seeing mid-single-digit to high-single-digit rate increases for both commercial and personal lines in P&C, and that’s what we expect to continue to see going forward.

TWST: You view workers’ comp as the riskiest line. Why is that, and which of your companies has the most exposure to workers’ comp?

Mr. Binner: Workers’ compensation is risky because it captures some of the most dramatic
parts of the property casualty cycle. Workers’ comp tends to be more exposed to the macroeconomic environment. Workers’ comp is based on payroll, so when the economy got bad with the recession, there was less business, and in turn, lower overall premiums collected, and claims as a percentage of the overall risk pool increased.

At same time, when people claim for workers’ comp, it’s harder to get them back to work. That’s the main problem. It’s not that more people get injured per se, but the severity of the claim is worse. And so, workers’ comp just tends to be one of those lines where it’s hard for companies to get the pricing right, also it’s a longer duration product, so they may rely more on investment income, which has not been a good proposition over the last few years, and so workers’ comp tends to be risky.

We’ve seen most of the reserve deficiencies from the last few underwriting years in workers’ compensation, meaning that reserves initially put up by insurance companies were not adequate. And so, as they take charges there and generally see higher loss cost trends, they’re pushing their price higher, so it’s a riskier product, but the reward is higher. We actually think that workers’ comp has seen the biggest price increases now, especially in states like California. Among the companies that we cover, a lot of them have workers’ comp, but AIG (AIG), Hartford (HIG) and Travelers (TRV) on the large-cap side have the most exposure there.

**“Workers’ comp has seen the biggest price increases now, especially in states like California.”**

As AIG, especially for AIG, the way we think AIG is generally undervalued, as it has a tax shield. They have a deferred tax asset as a byproduct of the way they issue and process annuities. So they have that and also have a larger deferred tax asset than we see with annuities, so there are a lot of levers they can pull that I think investors don’t appreciate. So I’d say that’s part of the biggest trend. It’s just that P&C names tend to have higher multiples than life names, and there’s still a lot of potential in life names, and what you’re seeing is likely a rotation back into life from P&C as the economy and stock market improve. That’s part of the biggest trend.

The only other thing I’d say is that personal lines tended to be very competitive for companies like Progressive, as reflected...
in its earnings. We cover them and have a “market perform” rating. So a lot of the comments that I have made so far about P&C is kind of more commercial line focused, but personal lines, auto insurance, homeowners, etc., comprise more than half of the P&C market in the U.S., so that’s been a competitive market. It’s hard for those larger companies to make market share gains. The advertising wars that they are engaged in are quite intense, and so for them, it’s just hard for us to get too excited on valuation.

TWST: What is the level of investor interest in the insurance sector right now, and is investor sentiment largely in line with your view of the space? Where does it diverge?

Mr. Binner: Your first question was the interest, so as the interest in the insurance sector is always low — who wants to talk about insurance stocks? So I love covering the sector, because it’s not well-followed, and it’s not well-understood broadly, and so it’s like people always kind of come to the insurance companies last. You see that with how the federal government’s attempting to supervise MET (MET), PRU (PRU) and AIG. They don’t have the resources, they don’t have the expertise, and so it’s a very slow progress.

I’d say that insurance companies are always a little bit below the radar, but in particular lately, I will say this again, especially life insurers. The life insurers have been in no man’s land for a lot of the large institutional investors because of their interest rate risk. Life insurers have more exposure to low interest rates than any other publicly traded company, because if you think about it, they basically sell social insurance; they’re like a pension fund with a discount rate that’s been lowered. And so I’d say that the sentiment on life insurers has been terrible. And I think that what you’re seeing, like I said before, is a better economy, better stock market, yields are improving recently, but it’s very low, and so I think we get people interested in cycling back into those names.

I think sentiment on the P&C side is pretty good. Property casualty lines are kind of easier to understand, like auto insurance rather than a variable annuity, from an investor perspective. And they don’t have the interest rate exposure; they have the higher pricing dynamic. And so it’s been easier for investors to be involved with P&C names.

TWST: What are your top four stock picks for 2013, and what do you like about each?

Mr. Binner: Prudential is our top pick. It has been a good call to be higher beta, higher risk, and we think that it’s going to continue, and so Prudential is our top pick. Even though the stock is up 22% year to date, it’s still only trading at seven times its 2014 earnings, so we think they had a great first quarter. We think they will have $8 in EPS this year and $9 in 2014. It’s a $75 stock, and so for us, that kind of valuation, upside to target probably about 10%, and you get a 2.5% dividend yield for large, well-managed, diversified global brand. That’s a very good opportunity with the market at a nominal all-time high to buy a top U.S. company for eight times earnings, and so that’s how cheap that the market has left these life insurance stocks.

I’d say number two; probably I’d still go with AIG. They have a life insurance business that we think is underappreciated. There you’re trading at 65% of GAAP book value. For their tax yield, they’re trading at something like 7.5 or eight times forward earnings, still very inexpensive, a lot of turnaround potential on their P&C business. I didn’t mention it earlier, but PRU, AIG, MET and Lincoln (LNC), which I’m going to mention in a second, all have the ability to buy back stock. We think they all have sufficient excess capital to buy back stock, and all of them, with the exception of PRU, are below book value. PRU is right at book value.

So when they enter into these buybacks, they’re accretive because they are below book value, and so when large, well-managed companies buy back stock below book value, that’s a good thing. That doesn’t mean that there aren’t other problems. Share buybacks is a theme that we think is going to be sustainable on how to support these names. With MET and Lincoln, I kind of lump them together. PRU, which is actually comprised of half Japanese life insurance — so they are half in Japan — and they have a very large fixed income asset management business, so that will give PRU less interest rate exposure than more classic insurance companies like MET and Lincoln.

MET and Lincoln are less expensive, both trading at about 85% of book value, excluding AOCI, at eight times forward earnings, and have good capital deployment stories. People worry about their exposure to lower interest rates, but from a capital perspective, we believe they can and will buy back stock attractively under book value. They will take that capital and buy stock with it when the markets are really worrying about their business exposure to interest rates, so those companies are forecasting a better outcome than the market is, quite frankly, when it comes to interest rates.

TWST: Thank you. (MES)

Note: Opinions and recommendations are as of 05/13/13.
ANALYST INTERVIEW

AMIT KUMAR — MACQUARIE GROUP LIMITED

AMIT KUMAR is Vice President and a Senior Analyst at Macquarie Group Limited. Mr. Kumar currently focuses on large-cap multiline insurers, midcap insurers and Bermudian reinsurers. In 2005, Mr. Kumar joined Fox-Pitt Kelton, which was acquired by Macquarie Securities Group in 2009. Prior to that, he worked at Dowling & Partners Securities, LLC, for four years. Mr. Kumar holds one MBA from the Barney School of Business at the University of Hartford, another MBA from Symbiosis Institute of International Business in India and a B.S. from BVM Engineering College, also in India.

SECTOR — INSURANCE (AEK801)

TWST: You recently downgraded ACGL, RE, PRE, VR and MHLD. Tell us about that group of downgrades and what factors contributed to it.

Mr. Kumar: In terms of the downgrade, I would say that there were two reasons why we changed our thought process. Number one was we were actually talking to some of the third-party capital providers, so we were looking at a lot of the data points coming out of the marketplace as to what the impact of third-party capital would be on the reinsurance renewals. The market renewals are on this time for next month and based on what we had heard, it was clear that there would be an abundance of capacity in the marketplace and hence pricing could be meaningfully down, that was number one.

Number two was the focus on the Florida markets. Now there has been some debate about Citizens (CIA). Citizens is the insurer of last resort in Florida and in the legislative session, there were several bills which would have moved demand from Citizens, which is again a quasipublic entity into the private market. Based on our analysis, we came up with a very small number asset incremental demand. So if you step back, there is excess capacity, and the new demand is not meaningful enough; it was clear that pricing would be under severe pressure at June 1 renewals.

TWST: Looking at your entire group, what’s going on in the rate environment? How do you expect rates to trend over the second half of this year?

Mr. Kumar: In terms of pricing, maybe if you bifurcate into commercial versus reinsurance, and if you start with commercial side and if you look at the Travelers (TRV) and other bigger companies, they’re still exhibiting very strong pricing improvement. For Travelers, in the latest report, they mentioned the pricing was up 10.4% in Q1; the other large commercial insurers have been in the ballpark. So those companies, the commercial insurers, are still getting very good rate increases. My sense is that those trends would persist going forward. Again, it’s debatable if they can get double-digit rate increases every quarter, but as I said, I do not see the rate momentum being lost on the commercial insurance side if you switch to the reinsurance side, and I’m talking mostly about the property catastrophe reinsurance companies. My view is that pricing at June 1 renewals would be down 10% to 20%, which obviously is a meaningful shift from the previous expectations in the market.

TWST: What’s going on in the regulatory and legislative environment for your group this year? What are the regulatory/legislative risks and opportunities out there?

Mr. Kumar: In terms of the regulatory changes, maybe it’s more of a statewide issue. I mentioned the changes in the Florida marketplace — one of the bills, it did pass in the Florida legislature, and essentially what this bill does is that it...
creates a clearinghouse mechanism, and simplistically from January 1, 2014, based on what rates are offered by the private carriers versus what rates Citizens is offering, there is a possibility that up to 200,000 policies could move from Citizens to the private primary market in Florida. So that’s obviously a positive for that marketplace. That said, apart from Florida, things are pretty quiet on the regulatory front. We often see, as you might have seen today, discussions on taxation, on Bermuda tax advantage, but again, our view is that we do not see any regulatory risk on the horizon for this group at least in the near future.

TWST: What other headwinds are you monitoring right now?

Mr. Kumar: I mean, obviously in this industry, you’re always — again going back, if you bifurcate, on the commercial you’re looking at the interest rate. Obviously, investment income is a very big component of the earnings for commercial insurers, so that is something that we’re monitoring. We’re monitoring the employment trends. We’re monitoring the macroeconomic trends. This is more so on the commercial insurance side. On the reinsurance side, we are very closely monitoring the advent of third-party capital and some of the deals that are being placed in the marketplace.

TWST: It seems like you’ve got a somewhat cautious view of the sector at the moment. What’s your overall advice to investors on how to play insurance at this point? What kinds of stocks and in what segments of the sector should they be looking for opportunities, if at all?

Mr. Kumar: I think maybe the starting point is that if you look at how much the sector has rallied, S&P is up 16.8%. If you look at commercial versus reinsurers and separate them out, if you look at reinsurance stocks, this is for the first time since 2000 that the reinsurance sector has outperformed the S&P in Q1 2013. I think investors should be asking: Has there been a real tangible new catalyst for the reinsurance sector to rally this hard? My biggest worry is that there is a massive sector rotation. We’ve already seen that start; the sector rotation out of the property catastrophe reinsurers might catch some people with their guard down. There are fundamental changes afoot in the reinsurance marketplace. As I said, the new capacity is becoming bigger, is becoming a very big deal in the marketplace and my view is that, either you have to adapt or perish.

The other name I mentioned was Travelers. If you look at Travelers, it’s a great proxy if you wanted to stick with mostly a U.S. carrier. If you look at pricing commentary, it was very strong in Q1. Last Friday we spent some time at their Claims University looking at the underwriting process. We walked away with incremental confidence in the underwriting process. Separately, I would say that if you look at unemployment, that’s a good proxy for payrolls, and unemployment is down to 7.5% for April — that compares to 8.1% for 2012. If you also look at the small business trends and look at the ADP small business survey, you will see that the small business trends are improving. Separately, if you’re
looking at the market surveys, let's say you look at the Council of Insurance Agents & Brokers or the MarketScout pricing survey, you'll see that pricing still remains stable in the 5% range. And finally, if you look at Travelers' balance sheet and analyze the quality of their loss reserves, you'll walk away saying that Travelers' loss reserves are redundant by 5%. So net net, in my mind, ACE and Travelers are great places to hide versus being in the property catastrophe reinsurance space at this time.

TWST: While we're on the topic of stocks that you like, is there another one or two from you group, since it's fairly large, that you're recommending for this year?

Mr. Kumar: I would mention two other names. One would be Argo Group (AGII). Again, it's a specialty insurance play, it trades at meaningful discount to book, it has a mid-single-digit ROE. Recently, we were on the road with Argo Group management, and if you look at some of the road maps they have laid down, the ROEs for Argo Group could reach close to double-digit or slightly lower by 2015. If that is the case, the stock will start trading a bit more in line with some of the peers. Currently, Argo is trading at the one of the biggest discounts to book value in the entire P&C space. So that's Argo Group.

The other name that I would mention is Employers Insurance Group (EIG). It's a workers' compensation specialist. That's more so on the, I would say, smaller-cap side. Again, the biggest draw with that name is workers' compensation market conditions have improved. They're getting double-digit rate increases. The loss cost trends have stabilized. If you go back to 2011, that was a time when there was a lot of debate if this line, which is workers' compensation line — with the performers in this line sort of blow up. Our analysis of the industry shows us that that is not the case. Recently we did a full industry analysis and walked away with increasing confidence on this line, so in my mind, if you're looking at the pricing, if you're looking at the loss cost trends and then you look at where the stock is trading at and our runoff value analysis, you can see that there is a meaningful upside to Employers Insurance Group. The other thing I would point out is there is a definite M&A interest in this sector. We've seen several companies acquired in the past.

TWST: Speaking of M&A, what's your outlook for the sector as a whole as far as M&A over the next several quarters?

Mr. Kumar: That's actually a great question. This reminds me of when we talked the first time. I think at that time I was extremely bullish on M&A in the sector. We would constantly put together these scenarios and come up with who would make sense, but in my mind, now my view has changed. I am definitely much more realistic at this point of time. I would say if you look if you look at coverage universe, if you look at some of the deals that have happened, the three stocks in my coverage universe which got acquired recently, Altera Capital, ticker ALTE, SeaBright Holdings, ticker SBX, Flagstone Holdings, ticker FSR, there were specific reasons. Two of these franchises had some challenges to deal with in their operations. So again, I would say that I'm much more cautious on M&A in this sector.

I guess the flip side would be that based on recent valuation one could use their stock as the currency, so let's say if you have a benign hurricane season, definitely there could be M&A on the reinsurance side as well as on the specialty side. Again, if you think about the Bermuda space, if you go back to the 1980s and 1990s, the biggest reinsurers at that time were created due to specific capacity shortages in the marketplace. I think the unfortunate reality today is that there are too many companies in the marketplace, and when that is the case, you end up being a price taker versus a price setter. So in my view, I would imagine some of the smaller names in my coverage universe in the Bermuda side, as well as some names in the specialty side, would be likely takeout candidates. But again, at the end of the day as a buyer, you're always facing asymmetrical information, and my view is that there has been a tendency over time for companies to avoid doing balance sheet deals if they can somehow acquire high-quality teams and make that process work instead.

TWST: What are some common misconceptions or complexities about any segment of insurance that you cover that you find new or generalist investors don't always fully comprehend?

Mr. Kumar: That's a good question. Yes, the one thing I would point out is that I think investors, if they look at the history of this space and if they look at the performance versus some of the other sectors, if you pay some attention to some of the metrics and issues facing the sector, you can make a lot of money. There are periods of great opportunities in the marketplace where a savvy investor would have had a meaningful return versus sort of staying out of the sector. So in my mind, again it might seem daunting from the outside, but once you sort of make the leap, it's a fairly easy sector. At the end of the day, it's all a function of demand and supply, it's a function of which insurance companies are doing a better job in addressing what the nature of the demand is and, as I said, the companies which have done a better job over time, those have traded at a premium multiple to book. So again, net net, as I said, there are very specific opportunities investing in this sector versus going and looking at some other sectors which have much higher betas, which are extremely volatile, and it's virtually impossible to be on top of the news flow.

TWST: Thank you. (MES)

Note: Opinions and recommendations are as of 05/21/13.

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BRETT HUFF — STEPHENS INC.

BRETT HUFF joined Stephens Inc. in April 2005 and is a Research Analyst covering payments and processing stocks, real estate information services stocks, and title insurance and insurance brokerage stocks. Previously, Mr. Huff was a Research Associate covering title, insurance broker and financial services technology companies. Before joining Stephens, he was an Associate Analyst at Southwest Securities, focused on the specialty retail industry. He also previously worked at OpenAir, Inc., a private software company in Boston which was subsequently purchased by NetSuite, Inc., where he held Director of Product Management and Director of Marketing positions. Before that, he worked at Deloitte Consulting as a Management Consultant. Mr. Huff obtained his A.B. in social studies from Harvard University and received an MBA, focusing on finance and strategy, from the Kellogg School of Management at Northwestern University.

SECTOR — INSURANCE

(AEK802) TWST: You cover both the brokers and the underwriters. What's the level of investor interest in each of those segments right now? And would you say that investor sentiment is largely in line with your assessment of opportunities in each segment or if it diverges, where and how?

Mr. Huff: I would say investor interest is reasonably high both in insurance brokerage and in title insurance. I’ll take insurance brokerage first. Investor interest in insurance brokerage is reasonably high now for two main reasons. Number one is that the rate or pricing environment in the insurance industry is positive now with rates growing low- to mid-single-digits over the last couple of years, and likely going to for the next couple of years after many, many years of being negative. And as a result, that has I think drawn investor attention, as obviously rising prices usually make an interesting long case.

The other reason that brokers I think are interesting is that insurance is in many ways tied to the general economic activity in the U.S., and while that’s been depressed over the past few years, it is slowly improving depending on the vertical or the geographic area or the size of business. The way that impacts the brokers is that businesses buy what’s called an exposure unit, and that’s just a unit of insurance that a business buys, and as businesses grow in revenue or they buy a new truck or they buy new buildings, the number of exposure units they need to buy goes up, and so that’s how it’s kind of tied to economic activity. And I think investors — and I think we’re close to this, we think that the economy slowly gets better, exposure units slowly get better as well. So the combination of positive rate and slowly improving exposure units we think sets up for a pretty nice long case for brokers.

Relative to investor sentiment, I think we saw that the rate environment in the low- to mid-single-digits was going to be fairly sustainable. I think in general, the market believes that now as well, and we also think that we’re roughly in line with slowly

Highlights

Brett Huff discusses his coverage of the insurance sector, in particular brokerage and title insurance. Mr. Huff says that investor interest is high in both areas, as the pricing environment is currently positive. He says that the interest in title insurance is because of the debate about the housing recovery, but he says there will be some near-term choppiness. Mr. Huff expects refinance activity to level off and then start to decline. Mr. Huff also discusses the M&A outlook for the title insurance segment, which he divides into three buckets.

Companies include: Stewart Information Services Corporation (STC); Fidelity National Financial (FNF); First American Financial Corporation (FAF); Brown & Brown (BRO); Arthur J Gallagher & Co. (AJG) and Willis Group Holdings Public Limited Company (WSH); Federal National Mortgage Association (FNMA) and Federal Home Loan Mortgage Corporation (FMCC).
improving economy in terms of exposure units what the market believes.

In terms of title insurance, there is quite a bit of interest in title insurance right now, primarily because I think there is a debate in the market about where we are in the housing recovery, and title insurance is one way to express that either we’re doing well or we’re at a point where housing is going to level off — title insurance is one way to express that kind of investment philosophy. In terms of what we think the industry is going to do, and therefore stocks are going to do, we continue to think that in the long term that the title insurance business in the three that we cover — Stewart Title (STC), FNF (FNF) and FAF (FAF) — will be interesting in the long term, simply because we think we’re in the early innings of the long-term housing recovery. We do think that investors should wait to look at this, simply because we’ve got some choppiness that we’re anticipating over the next few quarters.

So specifically that choppiness is refi activity. Refinancing activity has been very high over the last year, year and a half because rates are low. And we suspect with those refinancing transactions that growth will level off and then start to decline as most people will have refinanced over the next couple of quarters, and that will cause a headwind for the overall industry, so we’re waiting for that to get into the stocks or to get stocks get past that before we get more positive on those, even though we like the long term. And in terms of where investor sentiment is, as I mentioned there are some folks who still think that very early innings in a real estate recovery, and that any headwind from refi is coming down is not that consequential, and I think there is a significant group that believes that housing sentiment is a little ahead of itself and that the stocks are little rich. And so I think there is little bit of tug of war going on, on housing in general and therefore title stocks specifically.

TWST: What are the trends that you’re observing with regard to title order counts, and what are the implications of those trends for the companies in your group?

Mr. Huff: There are two types of title orders really, one is the purchase transactions and one is the refinance transactions. Purchase transactions we’ve seen growing 10% to 15% so far this year, which is a nice robust growth relative to years past as employment goes up, housing prices remain reasonable and rates remain low. So we’re seeing improvement there that’s better than we expected at the beginning of the year. And the other type of order flow that we’re viewing is the refinance transaction, and we’re seeing those going up slightly and/or leveling off a little bit, sort of alternating between those two, and that’s really dependent a lot on rates.

So as rates pick up a little bit, you’ll see that fall off a little bit, but you might have a month where rates came in a little bit, and therefore you’ll see the refi transactions rise a little bit. But like I said, we continue to expect about 14% or 15% unit growth in purchase transactions over the next two years that includes both new and existing homes, and then we expect overall the refi transactions to be negative in the 15%-17% in 2013, and more like 40%-50% down in 2014 as refis roll over as we think that they will in the back half of this year.

TWST: What regulatory issues are you monitoring at the moment that could have an impact on your group?

Mr. Huff: Well, there are the regulatory issues for title insurance, which I think are less acute than they are for banks, for provision of loans, defaults and things like that. While we’ll always pay attention to the regulatory environment for title, we don’t think there are any big issues out there on the horizon for title insurance right now. We think title insurance, frankly, is one of the keys to a healthy housing recovery, simply because lenders in general won’t loan money to consumers unless there is a title insurance policy associated with that particular title and property. So I think that the title insurance actually sits in a reasonably good place overall.

However, there is one thing that’s going on that we’re paying attention to, and that’s called the introduction of a qualified mortgage, or QM. And the qualified mortgage is a regulatory idea that a particular mortgage needs to have specific qualities to it; qualities that the regulators think make it a safer mortgage for the consumer who is buying it and a more transparent mortgage for the secondary market that might be buying it. I think the analogy that I would use is what I think many would know as a conforming loan as defined by Fannie (FNMA) and Freddie (FMCC). I think this is sort of a more complex and probably more sophisticated extension of that idea. And whenever a new regulation hasn’t been fully implemented yet, and whenever that QM regulation is fully implemented, it always causes some confusion in the market. It’s not specifically directed at title, but in general that could give pause or it could slow down the housing market activity briefly. But both lenders and others in the market, the value chain for providing mortgages and loaning for homes, will need to digest how QM needs to work, and then we’ll move on. But that’s the main thing that we see here in the next few quarters that we think we’ll be paying attention to.

TWST: So outside of any regulatory issues, what are
some other significant headwinds that could be on the horizon for your group, and which companies would you say have the most exposure to each of the headwinds that you’re looking at?

Mr. Huff: I think the biggest headwind as we outlined in the title industry trends when we first started talking, the most important headwind that we, and we think investors, are paying attention to is what happens to refinance transactions over the next few quarters. As I mentioned, the refi has been very strong and growing up until the last few months, growing very rapidly and then starting to level out a little bit. And we think that those will level off further and then start to go down by the end of the year, and that is a source of revenue for all the title companies that is in varying degrees of their revenue mix.

If we look at these different companies, the three companies we cover, we think Stewart is best positioned to handle this downturn in refi, simply because their mix of revenue of residential title revenue is 70% purchase and 30% refi. So relatively low percentage of refi, but we think FNF and FAF have a relatively higher percentage of refi in their current mix, about 30% purchase and 70% refi, so we think that the headwind for FAF and FNF will be a little bit stronger than for STC when that refi volumes starts to taper. And the result, we think, will be that Stewart’s revenue and earnings will be more stable and even up in the next year or two, whereas FAF and FNF will be more flattish. For title, we think that’s the main headwind that we see coming in the next year or so.

TWST: What’s your outlook for M&A in each segment of the insurance sector that you cover? And which are the companies that you could foresee doing deals and what types of transactions might those be?

Mr. Huff: I think there are three buckets of M&A for title. There is buying smaller title companies; there is buying ancillary services, which is other mortgage and housing-related data and information and processing services; and then there is buying unrelated businesses — simply just putting excess cash to work in non-real estate and non-title businesses.

So let me take the first one on buying more title share. I think the answer is that the ones that we see most likely to buy additional title share would be FAF and Stewart, simply because their size is a little bit smaller. I think FNF being the market leader in terms of share at roughly 35%, I think it will be hard for them to buy additional title assets.

If we look at the second bucket, which broadly described as ancillary mortgage and housing-related services, we think all three of the title players would benefit from buying more of these things, so that includes everything from sort of quality control and business process outsourcing for banks as they do their loan process, all the way to helping run the default management process that’s important right now, all the way to doing data and analytics, providing data analytics that plug into the services or plug into the lending solutions that banks use. So it’s a pretty broadly defined group of businesses. Each of the three title companies already does some of these ancillary services. It’s a fairly logical cross sale for these three folks to make to other parts of the bank/lender or related parts of the bank, so that’s why it makes sense.

The attraction to these assets is, as I mentioned, they already have a sales channel built to sell to banks, so they could cross sell more products too. And then number two, they tend to be higher-margin businesses and more recurring businesses, if they buy the right segments of that ancillary revenue.

And then lately are the noncore asset purchases, and I think the main focus here would be FNF. FNF historically has deployed excess capital buying not just title and related mortgage services businesses, but they’ve also bought noncore or nontitle assets, including restaurants, payments processing companies, even things like distressed timberlands, especially over the last few years where they found what they thought were good deals in distressed situations. We think that FNF, it’s still — we think FNF is still interested in growing its restaurant business in particular, and so we think they are likely focused on that. I mean, in terms of timing of that we don’t know, but that’s, we think, something they are still paying attention to. So that’s kind of what we see in terms of consolidation and M&A in the business.

TWST: You’ve got several stocks with “equal weight” ratings. Are there any common themes we can derive from that group of “equal weight” ratings, and what would be catalysts for you to consider upgrades on some of those?

Mr. Huff: Let me take the title insurers first, because I think that’s a pretty common theme and pretty easy to explain. So as we mentioned, we’re kind of waiting out this refi decline when it happens. We think the stocks are range-bound until we get through that, and then once we’re through that near-medium-term issue, we think the stocks likely become more interesting, especially if they are trading down at all from where they are. The closer they get to
book value the more interesting we think they are, so once we get through there, we think the stocks get more interesting.

As I mentioned, we think Stewart is relatively well-positioned given its more favorable mix, and we also think that Stewart could be interesting sooner than the other two companies, simply because it has some company-specific things that it’s doing. Its operational execution prior to a new CEO coming on about a year and a half ago was subpar for the industry, and as a result they tend to have a lower multiple both on book value and on EPS. We think they are doing good work on improving their operations, have done so and will continue to do so. So we think there are some company-specific things that Stewart could drive to provide upside to expectations in 2014, but we’re still in wait-and-see mode to see how those things pan out.

In terms of more specific answers on FAF and FNF, again, once we get through the range-bound nature of what we think will happen to the stocks during this refi transition, we think both FAF and FNF are very well-run companies. FNF in particular is well-known as being the margin leader; title pretax margins is the main metric that folks use, and they’ve been the historic leader over many, many years. We expect that to continue, simply because we think they have the tightest cost management processes in the business. And in addition, FNF is known for buying stock back particularly at or just above book value, so we think that helps provide somewhat of a floor to the stock, and book value is in the low $20, $22, $23.

In terms of FAF, we think that stock is interesting once we’re past this refi decline choppiness potentially, simply because we think that FAF specifically in our view has been to really push centralization in particular unlike the other title businesses that we cover. They have been very focused on centralizing their title underwriting process and their systems, and we think that allows them to use more cost-effective underwriting, in particular using more offshore underwriting, which we think will be helpful to margins going forward. So we think that is the particular thing that we’re watching on FAF.

In terms of brokers, the three stocks that we cover there are Brown & Brown (BRO), Arthur Gallagher (AJG) and Willis (WSH). Right now we like Brown & Brown the best, simply because we think that Brown & Brown has the most upside to gain from exposure units getting better. It tends to sell to the middle market of the United States. The middle market businesses generally have not led us out of this recession as they usually do, so we think they probably have the most organic growth and incremental margin upside yet to go.

That said, we also really like Gallagher, simply because they’ve been the best operators of the insurance broker group over the last couple of years with the earliest and best and most consistent organic growth. We think that’s a function of just their tight expense controls, and I think their sales execution has just been very good. We like them because we think they have a good amount of capital to deploy, and we think that the market in general is underestimating the amount of capital that they’ll deploy to buy additional growth and additional profitability. That’s our key thesis there.

And then in terms of Willis, that’s a stock that we’re watching closely. Willis has a new CEO that has been doing a business review. We think we’ll understand the results of this business review come their Analyst Day later early in the fall. We are in wait-and-see mode on Willis, while we think the new CEO has a very clear and positive operating philosophy, which is that he is very focused on return on invested capital both inorganically in terms of buying businesses and organically in terms of where to put money for investment. But we’re in wait-and-see mode on Willis to see where they pan out if there is going to be any announcements and business changes, etc., that we will get at that Analyst Day. And once we get through that, I think it will be easier to make a judgment on Willis.

TWST: Thank you. (MES)

Note: Opinions and recommendations are as of 05/21/13.
Protective Life Corporation (PL)

JOHN D. JOHNS is Chairman, President and CEO of Protective Life Corporation. He joined Protective in 1993 as Executive Vice President and Chief Financial Officer. He became the company’s Chief Executive Officer in January 2002. Prior to joining Protective, Mr. Johns served as General Counsel of Sonat, Inc., a diversified energy company. Prior to joining Sonat, Mr. Johns was a Founding Partner of the law firm Maynard Cooper & Gale. Throughout his career, Mr. Johns has been actively engaged in community and philanthropic service. He has served as the Chairman of the Business Council of Alabama, the McWane Science Center and the Greater Alabama Council, Boy Scouts of America. He is Immediate Past Chairman of the Birmingham Business Alliance, the umbrella chamber of commerce organization for the greater Birmingham region. He also currently serves on the executive committees of the boards of the American Council of Life Insurers and the Financial Services Roundtable in Washington, D.C. Mr. Johns was awarded a B.A. from the University of Alabama in 1974. He also received a J.D. from Harvard Law School and an MBA from Harvard Business School, both in 1978.

SECTOR — INSURANCE

(AXA600) TWST: Can you begin with brief introduction to Protective Life, including some highlights from the company’s history and an overview of your business segments?

Mr. Johns: Protective Life was founded in 1907, and we’ve been a public company for that entire period of time. We’re proud of the consistency in leadership we’ve had during that time: Protective has only had six chief executive officers since its founding.

Last year, we generated about $3.6 billion in revenue, and we have approximately $58 billion of GAAP assets. As for our footprint, we’re truly a national company. We do business throughout the United States. Our corporate offices are in Birmingham, Alabama, but we have major servicing centers in Chicago and Cincinnati. In terms of our products, we sell universal life products and retirement savings products, primarily annuities, through thousands of independent distributors across the country. In addition, we sell extended service contracts and related products through automobile dealers.

I’ll also quickly point out another part of our profile that’s very important to us is that we believe we have industry-leading capabilities in acquisitions of other insurance companies or blocks of insurance business. We’ve successfully completed about 46 transactions over the last 30 years, and I think we’re generally regarded in the industry as one of the most proficient and forward-thinking companies in the area of acquisitions.

TWST: Last month you announced the acquisition of MONY Life Insurance Company. How does that acquisition fit into your overall strategy?

Mr. Johns: We consider our acquisitions to be a routine part of our business. So we separately segment in our financials the results of our acquired businesses, and as I mentioned a moment ago, we’ve been doing acquisitions successfully for many years. MONY is rather a landmark transaction for us. We’re investing a total of about $1.09 billion to acquire the stock of MONY Life Insurance Company, and also we’re reinsuring some related business from an affiliate. The seller here are certain subsidiaries of AXA SA, the large, global, French insurance company that also has other ongoing life insurance operations in the United States and, of course, throughout the world. Again, it’s a very substantial transaction for us. We’re acquiring about 660,000 policies, approximately $10 billion in assets and reserves, and we expect the deal to be highly accretive to our earnings as soon as we close the transaction. We also expect, as a result of the transaction, to see a nice enhancement to our return on equity, which is obviously a critical financial metric for our company or for any insurance company.

TWST: As you look forward, what other types of operational or geographic acquisitions could make the most sense for you?

Mr. Johns: We’re always on the lookout for acquisitions. However, by virtue of the size of the recent acquisition and the normal time that it takes to get a transaction such as this through the regulatory process, closed and then assimilated, we’ll probably be out of the acquisitions business for a while. One of the attractive features of this acquisition, though, is that about 50% of the capital we’ve committed to the transaction will be returned to us in only a couple of years. So we should be back in a position from a financial point of view to be at least looking at new transactions sometime later next year or certainly into the following year.

We’re very open-minded in terms of what we like to acquire. Our specialty is in acquiring life insurance policies. We’re extremely skilled at the complex task of bringing policies from another company’s systems and integrating them into ours. We think that we add a lot of value not only generally by finding some expense saves, but also by virtue of our ability to bring over another company’s employees and integrate them into our company while maintaining a consistently high quality of service to the policyholder.
after we transition the business.

TWST: You introduced some new universal life products at the beginning of this year. Tell us about your new offerings and the demand you’re seeing for those products so far.

Mr. Johns: Yes, absolutely. We and most companies in the industry refreshed our life insurance portfolio toward the end of last year partly in response to new regulatory requirements, but also as a part of our overall focus of trying to understand better what consumers need and want. I might observe that the life insurance industry as a whole has not been a high-growth industry for decades. Ownership of individual life insurance in this country has been declining on an annual basis for more than 40 years. At the same time, we believe the need for life insurance, given the financial insecurity that a lot of people face today, is probably at an all-time high. At the same time, it’s well-documented that the United States and indeed many countries around the world are facing a retirement savings crisis. Increasingly, we find that even people that have been relatively high earners throughout their careers are not adequately preparing for retirement. They have inadequate savings, and they’re just not going to be able to enjoy a comfortable retirement at a normal retirement age. So we’ve thought a lot about that. In fact, we’ve recently refined both our brand as well as our business model to sharpen our focus on addressing this issue head on.

Our view is that there are many, many barriers that the industry itself has created to penetrating the markets where there is a lot of pent-up demand and need for our products. We can identify a number of those barriers — certainly affordability is a key issue for most people but also we think there are other softer issues that are equally important. For example, we think industry products are generally too complicated. It’s only natural that people are reluctant to buy things they don’t think they understand. In addition, we think that in the case of life insurance, the process that one must go through in order to acquire a policy is burdensome and complicated. So all our strategies are built around trying to develop a superior knowledge of what’s going on inside the mind of the consumer, to try to understand better what they want, what they need and what’s keeping them from taking action to protect themselves and their families. So everything from our brand to the design of our product, which I’ll get back to in just a moment, to our service capabilities, to our call center technology, to really promoting the culture of standing up for the customer and listening to the voice of the customer, all these things are being blended now into a new and, we think, pretty exciting retail strategy.

Our recently released UL products are good examples of the innovations that we’ve made. It will sound a little simple, but I think it’s actually quite important to addressing the needs of consumers. Currently, a lot of the insurance sold in this country is term insurance. The typical term product, by design, causes the premium to rise materially at the end of the guarantee period. Of course, consumers are always advised that this will happen and that they should be prepared to find another insurance solution when the premium starts to go up. But what we’ve done is to change our product design so that premium will stay constant for a very long period of time, but the face amount of the insurance will start to decline over time at the end of the guaranteed period. We are finding that consumers really like this because it provides continuity of some coverage and may in fact fit their lifestyle better. It also gives people time to still have some meaningful insurance coverage while they rethink what they want to do. They’re not faced with suddenly reaching a cliff where they either have to drop the policy or see the premium skyrocket. So it’s a simple kind of idea, but actually, we think, one that is being well-received by consumers. Application counts and sales of our new series of universal life products are right on our plan. We were planning $130 million of life sales this year. We had about $47 million in the first quarter. So I think those numbers speak for themselves.

“Overall, our financial performance has actually been quite robust, even though we do face some headwinds because of the macroeconomic environment and the interest rate situation in particular.”

TWST: So you’ve talked about a few different products. Are there any other product categories or specific products that you didn’t mention that are experiencing good demand?

Mr. Johns: Yes. We’ve been very successful, perhaps a bit too successful, with our variable annuity products. But the sales there have been quite robust. This is a retirement savings product group in which the funds within the product are invested in various mutual funds which can be selected by the policyholder.

TWST: Which product categories are experiencing challenges in this environment, and how are you dealing with those challenges?

Mr. Johns: Products that are interest-rate-sensitive, such as fixed annuities, are most challenging now. I know we, and indeed many companies in our industry, have actually had to raise the price of some of our long-term life insurance products because those products depend upon our investment returns within the product to support the death benefits that we guarantee to pay. And in a low interest rate environment, we have to raise prices in order to achieve the same level of benefit to the policyholder. So interest rates have been a challenge, both in terms of sales but also in terms of just maintaining the income we need to continue to support the products that are in our in-force block. Having said that, though, I believe we and most insurance companies are actually managing through this low interest rate environment pretty well. We had record level of earnings last year — the highest level of operating earnings in our history going back all the way to 1907. We also saw our statutory capital, our statutory capital, reach an all-time high of about $3.3 billion, up about 11%. And so overall, our financial performance has actually been quite robust, even though we do face some headwinds because of the macroeconomic environment and the interest rate situation in particular.

TWST: What do you believe are the key competitive advantages that differentiate you in the marketplace?
Mr. Johns: I do believe that we have a distinctive, I’d like to think even unique, and certainly differentiated overall business model within the life insurance space. We have a three-pronged franchise for deploying capital that fits together synergistically. I think what really powers the model is the fact that we have a very well-sized retail operation. We’re certainly competitive, and we’re in most distribution systems. But that’s not the only engine of growth that we have within the company. We don’t have to live and die exclusively on our ability to compete every day on price in life insurance and annuity sales. What I mean is that our company has the capacity to generate lots of capital, actually more than we believe we can prudently invest in our retail businesses, even while we’re growing them. So we then look to the other ways that we can deploy capital. This includes share repurchase and dividends, as well as our very distinctive and industry-leading acquisitions franchise. So we think there’s really power and synergy among having those three different opportunities to deploy capital.

“We view all of this as kind of a virtuous cycle where we’re constantly monitoring our opportunities to deploy capital in retail, share repurchase, dividend and acquisitions, and everything we do in those three areas reinforces the other two.”

As I say, it gives us a lot of flexibility to grow the retail businesses when conditions are favorable but not feel compelled to maintain market share when market conditions are unfavorable. We’ve indicated that our long-term goal is to return 50% of our after-tax GAAP earnings to share owners through a combination of share repurchase and dividend; we absolutely achieved that in 2012. We have suspended our share repurchase temporarily as a means of financing in part the MONY transaction, but we do believe we will have the capacity in future periods to resume share repurchase at that level and that will be an even higher level of shares repurchased, because the MONY transaction will actually add a lot of earnings power to the company as well. And then lastly, the acquisitions franchise actually reinforces the retail franchise. Every time we go out and acquire a new big block of policies like this recent one — which will add more than 600,000 policies to our in force — it helps reduce our incremental costs, it helps cover our overhead even more, it makes our retail businesses more competitive and potentially successful. At the same time, all the know-how we’re picking up about what’s inside of the minds of consumers on the retail side is really helping us think through acquisitions and understand the context of the acquisition and perhaps even opportunities in some transactions to do new business with these new customers that we’re acquiring through the acquisitions. I will say, as I mentioned earlier, we’ve done 46 successful transactions over the last 30 years or so, and the know-how we’ve picked up through those transactions really does make a difference in terms of our ability to compete successfully when an acquisition is available.

So we view all of this as kind of a virtuous cycle where we’re constantly monitoring our opportunities to deploy capital in retail, share repurchase, dividend and acquisitions, and everything we do in those three areas reinforces the other two. Really there are very few companies, if any, that have the same capability to do that. We certainly have strong competitors on the M&A side. We certainly have strong competitors in the retail side. But I don’t believe we have any competitor that has the same level of capabilities on both sides of the equation as we do, and we think that that’s a differentiator for us.

TWST: Do you think the investment community has a good understanding of your story and your value proposition? And what complexities or nuances about the company do investors commonly misunderstand?

Mr. Johns: I’m not sure we’ve done as good a job as we could to really explain the power and value of that three-pronged franchise that I just mentioned. I don’t think we’ve really gotten the word out how the synergy works among those three opportunities to deploy capital. I will also say that as a general proposition, I think very few investors really feel comfortable analyzing the financial fundamentals of life insurance companies. There is a lot of industry-specific terminology. There are a lot of accounting practices that are unique to the insurance industry. You do have an interplay between statutory or regulatory accounting and GAAP accounting. And even the products are complicated. I think that when things are complicated, people tend to shy away sometimes from making an investment. But I feel we are doing some things to attack that head on, and this probably should be a differentiator of our company in the minds of investors. Several years ago, we began meeting in late fall each year with investors, and we lay out in detail — by segment and with a very robust disclosure of assumptions — our financial plan for the next year. We do it at the segment level, and it is really our plan; it is the same plan for investors and the same plan that we use for purposes of our executive compensation and bonus structure. So we try to make our internal view of our company as transparent and clear and understandable to investors as we reasonably can. We also provide two additional years of financial projections or financial models.

Now, to add another level of transparency for investors, on a quarterly basis, after we announce our earnings, we have a conference call in which we reconcile the results back to the plan. We put that information on our website; it is all public information. So we’ve told investors at the beginning of the year, here’s the plan. We put that information on, and this probably should be a differentiator of our company in the minds of investors. Several years ago, we began meeting in late fall each year with investors, and we lay out in detail — by segment and with a very robust disclosure of assumptions — our financial plan for the next year. We do it at the segment level, and it is really our plan; it is the same plan for investors and the same plan that we use for purposes of our executive compensation and bonus structure. So we try to make our internal view of our company as transparent and clear and understandable to investors as we reasonably can. We also provide two additional years of financial projections or financial models.

I’ll say a third thing, which is we strive to have a relatively straightforward business model within our industry. We do business essentially within the United States. We only have three major retail product lines. What we do in the acquisition space is very straightforward. We acquire small companies or blocks or books of insurance policies. So we don’t have a lot of noise in our numbers arising from things like currency volatility. And so again, we believe that that’s another sort of differentiator for our company:
A, we’ve laid out the business for you in as transparent a way as we know how; B, we hold ourselves accountable on a quarterly basis; and C, we really strive to keep the business model itself as simple as we can so that investors can be more comfortable that they can get their arms around how it works. So again, we’re not perfect, and our models and plans are not perfect, but we have confidence now after four years of using this approach that the system works. I will also say that during that period of time, we’ve exceeded the plan that we’ve laid out in every annual period.

TWST: What is happening for you in the regulatory environment? What are significant regulatory challenges or opportunities on the horizon?

Mr. Johns: That’s an important issue within our industry. As I’m sure you know, the insurance industry is and has been for many years primarily regulated at the state level. Our primary regulators are the insurance regulators in the states in which our companies are domiciled, but we’re also subject to regulation in every state and the District of Columbia.

The primary group that oversees and sets the standards for state regulation is the National Association of Insurance Commissioners. They meet periodically to consider changes, advancements in the state regulatory rules. This group often engages with the primary insurance trade association, which is the America Council of Life Insurers, ACLI. I would say that I think in the last couple of years our industry has made tremendous progress in engaging in very constructive dialog with our regulators. They set the rules, and we follow their rules, to be sure. But they’ve shown an increasing openness to wanting to understand industry positions on rules as they contemplate changes in them and the impact that changes in insurance regulation will have on the financial health of the industry and on consumers. So I’d say on the state regulatory front, we face a number of complex issues, but I’m encouraged because I believe we’ve got some top-flight people in the regulatory community that are doing what they need to do to ensure the solvency of the system but are also open to how rules can evolve in ways that fit the modern era, that work to the advantage of consumers in a lot of ways. But another thing to mention about insurance regulation is now the federal government increasingly is showing interest in and has legal authority now to be involved in some important ways in the regulation industry.

TWST: What is your five to seven year plan for Protective Life?

Mr. Johns: I’ll say several things. One, we are strong believers that the best way to create shareholder value is through very steady and consistent growth in earnings. We want to be a “Steady Eddie.” We want to keep compounding our growth and increasing our dividend when we can, keep buying back stock, keep evolving the retail model to make it differentiated because of the consumer-centric approach, and then when acquisitions come along, jump on them opportunistically. Again, the way we envision the business model working is to achieve 5% or 6% growth from our organic businesses, then add to that 4% to 5% through our share repurchase and then when a major acquisition comes along seize the opportunity to increase the growth rate up above our organic growth rate in earnings. We see that as a very constructive way to create value for shareholders.

TWST: Thank you. (MES

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Stewart Information Services Corporation (STC)

MATT MORRIS serves as the Chief Executive Officer of Stewart Information Services Corporation. Previously, Mr. Morris held the positions of Senior Executive Vice President for Stewart Information Services Corporation, Stewart Title Company and Stewart Title Guaranty Company. Mr. Morris has also served as the President of Stewart Professional Solutions, which oversees the corporate and back office functions, including marketing, information technology services, employee services, finance and accounting, the strategy and program management office, and audit/risk management for the Stewart companies. Mr. Morris rejoined Stewart Information Services Corporation in May 2004 to serve as Senior Vice President of planning and development. Prior to that, Mr. Morris most recently served as Director for a strategic litigation-consulting firm, offering trial and settlement sciences and communications strategy. Mr. Morris graduated from Southern Methodist University with a Bachelor of Business Administration in organizational behavior and business policy, and received his MBA from the University of Texas with a concentration in finance.

SECTOR — INSURANCE

(AXA601) TWST: Can you begin with a brief introduction to Stewart Information Services, including some highlights from the company’s history and an overview of your current operations?

Mr. Morris: 2013 is our 120th anniversary for the company. We started in Galveston back in 1893 and have had a long history serving the real estate industry, providing title insurance and settlement services in addition to some ancillary offerings related to real estate transactions. Today, we are a multinational company with operations around the globe. We’ve gone through some significant restructuring since the downturn in housing, making changes to our operating model to adapt to the changing times.

Currently, we have more than 7,500 policy-issuing offices and agencies. We operate through our direct channel of Stewart Title office locations as well as our independent agency channel. Our international group is strongest in Canada, but we also operate throughout Europe, Australia and some of Latin America. And then we have another operating group that provides mortgage services to primarily large national or regional mortgage lenders and servicers. We have seen the most growth in this area, as we provide outsourcing work for lenders including centralized origination title, loss mitigation/default resolution, default title, REO asset solutions and other mortgage-outsourcing solutions.

TWST: In which of your business lines do you currently see the best opportunities for growth? What is driving that growth, and how are you positioning the company to take advantage of potential opportunities?

Mr. Morris: We really see opportunities for growth in all four channels. The housing recovery we’re starting to see across the country is enhancing our business not only in the number of transactions but also rising real estate prices. Our company is more focused on the resale markets than the refinance market, but we are experiencing growth from continued refinancing transactions. So we see some positive indicators just from the economic environment overall.

In addition to that, we’ve spent the last five years restructuring our company for much more scalable operations, and we have spent a lot of time and effort on simplifying and aligning our organization around customer channels. We have been centralizing, moving to a shared service environment for all of our back office, which enables us not only to have a much more flexible cost structure, but also enhances our ability to enter new markets with a much more scalable platform.

We see continued growth in our mortgage services segment as well, seeing opportunities tied to the increased compliance and regulatory oversight around mortgage lending. We have a great team, great processes, great compliance and oversight to enhance an increasingly complex and regulated mortgage market. We see our ability to provide assurances, provide trustworthy solutions, and outsourcing options to lenders and mortgage providers. There are a lot of unknowns in the mortgage market right now, and we are well-positioned to support mortgage lenders as they continue to meet more stringent compliance guidelines.

TWST: What is happening in the regulatory environment as it relates to your business? What regulatory challenges or opportunities are on the horizon for you?

Mr. Morris: Looking at the data, the challenges or probably opportunities if we look at them correctly, the Consumer Financial Protection Bureau as a result of Dodd-Frank is composing significant changes not only in the mortgage lending industry, but also to the settlement transaction itself — everything from forms and disclosures and timing of providing closing information. So there is a lot of regulation, and it’s not finalized.

We continue to have conversations with CFPB, and we are very intent on staying close to those regulations and what is coming out communicating with the CFPB, understanding what their norms are, understanding what their goals are. There’s going
to be changes in the market, and we see having opportunities to leverage our trusted and longstanding name, reputation, compliance and integrity to position us to take some of the burdens from our customers and provide a greater degree of security to our customers going forward with these new rules.

“\textbf{In our mortgage services segment, we continue to offer additional services to mortgage lenders, and we will continue to expand those offerings, potentially through some tuck-in acquisitions or new services to mortgage lenders.}”

\textbf{TWST: How would you describe the competitive landscape for your business, and what do you believe differentiates Stewart Information Services?}

\textbf{Mr. Morris:} So I’d say that the last 10, 15 years we’ve seen some pretty significant changes and consolidation in the industry. Right now we do see some smaller players entering the market. There’s been a lot of transition as the market downturn occurred, and there are a lot of title companies that are no longer in business. I think the industry overall is much more consolidated, much more risk-averse. I do see market differentiation going forward, and we are really focused on service and quality.

In the past we’ve talked about being a data or a technology company, both of which are essential to our business, but at the end of the day, we are a service provider. We’ve made significant changes to make sure that we are providing the highest level of service. It’s the reason why we pursue residential resell business over refinance business. That’s the reason why we see significant opportunity in our commercial business. We’ve done significant vetting of our independent agency base, and actually, we cancelled half of our independent agents over the last several years, really focusing on that quality of agents, our ability to deliver a higher level of service and customer experience.

\textbf{TWST: What is your five-year plan for growth?}

\textbf{Mr. Morris:} We have growth initiatives under each of our operating divisions previously mentioned. Our direct channel will see growth focused primarily on larger markets, primarily in the West. I think we said in the financial press release right now that 60% of title insurance is coming from our independent agents, and 40% from direct. We’d like that to be closer to 50:50, and we have some growth initiatives on the direct side to get there. In the independent agency channel, there are several states that we’re targeting growth in, primarily in the East. Our international channel is reviewing a couple other countries, and we need better coverage in places like Australia to make sure we have a significant market share in those markets. In our mortgage services segment, we continue to offer additional services to mortgage lenders, and we will continue to expand those offerings, potentially through some tuck-in acquisitions or new services to mortgage lenders.

\textbf{TWST: Do you think the investment community has a good understanding of your story? What are some common misconceptions or complexities about Stewart Information Services, and can you shed some light on them for us?}

\textbf{Mr. Morris:} That’s a good question. I don’t think the investment community has a great understanding of our business, and then part of that we realize is our need to get out there and to tell our story. I think we’ve been under the shadow of some larger peers in our industry, and we have made a concerted effort over the last year to tell our story, and the significant changes we have made to propel us moving forward. The title industry is relatively small. Most people don’t necessarily understand the components of what we do and the common misconceptions. While technology has advanced our work, still requires expertise and great people to reduce our risk and deliver quality products, and so that’s one misconception that we’re often telling people about.

The other misconception is that people think our cost structure should mirror the rest of the insurance industry, and at the end of the day, it’s really assurance. When people think about insurance they think about the assumption of risk. In title insurance, it is really the elimination of risk, and majority of our cost structure goes into eliminating the risk. One out of every four transactions has a flaw in the title.

\textbf{TWST: Can you introduce us to the key members of your core management team? What unique strengths do they bring to the table?}

\textbf{Mr. Morris:} I mentioned we went through a significant simplification and alignment of our management team, and I look back to the changes that we made that really centralizing and moving into a shared services environment. Much of our team is relatively new to their positions, but they have great backgrounds to get us where we need to go. Allen Berryman is our CFO and has been crucial to centralizing our accounting and moving to an ERP, enhancing financial planning. We’ve also centralized in information technology with Murshid Khan. Murshid came to us from Disney and really led efforts to pull our disparate data centers and systems together. We also have centralization under Susan McLauchlan and marketing under John Arcidiacono. These functional areas have made great strides in analyzing our cost structure and bringing efficiencies.

On the operations side, we have outstanding leaders with tremendous experience. On our direct channel, Glenn Clements has been with us for 40 years and has great relationships, great expertise, and knowing and understanding the business overall. Our Group President of agency operations, George Houghton, was actually an independent agent and came to work for us after selling his company. He definitely understands the role of independent agent, having lived and been very successful at it, and has made a tremendous impact on our organization. In international, Steve Lessack has done great things, and we’ve consolidated all international operations for him and continue to look for opportunities. He understands our core products and how that related to various governments. In our mortgage services channel, Jason Nadeau is actually on his second duty with Stewart. He has a strong technology background, strong understanding of mortgage lenders and of those processes, efficiency and centralized services. We’ve consolidated all legal operations under our Chief Legal Officer, John Killea, and we...
have a tremendous underwriting team with a business focus.

TWST: What do you believe are the most compelling reasons investors might want to take a closer look at Stewart, particularly this year?

Mr. Morris: The overall market continues to perform well, and there’s some optimism with housing and with real estate prices. More importantly, we want people to understand that we have made significant changes to our overall structure and our ability to outperform in the market. I think people should see the changes that we’ve made and how our incremental margins should help us support the growth and stability of our business. We are more focused on resale transactions and thus not as exposed to the refinancing highs. There are strong commercial opportunities. And really I think the other reason is the growth we’ve had in mortgage services and our ability to continue to capitalize on opportunities there.

So again, we experienced in the downturn significant headwind that really damaged our balance sheet, our financial strength, and that has been restored. We’re seeing much better margins than we had in the past and still have some work to do on our cost structure. We’re very much focused on using our new model and seeing how much revenue we can generate and sales we can capture using what we think is a great team, great people, great brand and our 120-year history. We think that has a lot of value in the market right now that we want to make sure that our customers are using a trusted provider that is known for integrity and longevity.

TWST: Thank you. (MES)

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COMPANY INTERVIEW

Arch Capital Group Ltd. (ACGL)

CONSTANTINE IORDANOU is one of the founding members of Arch Capital Group Ltd., and currently serves as a Director, Chairman, President and Chief Executive Officer of the firm. Arch Capital is a Bermuda-based company that writes insurance and reinsurance on a worldwide basis through its operations in Bermuda, the United States, Europe and Canada. Before his role at Arch Capital, Mr. Iordanou was the CEO of Zurich North America, and before that, he held senior executive positions with Berkshire Hathaway Group and American International Group. Mr. Iordanou serves as a Director of Verisk Analytics, Inc., the American Insurance Association and is Chairman of The Association of Bermuda Insurers & Reinsurers. He is also a founding member of the Pancyprian Association of America, established in 1975, and he is one of its seven lifetime trustees. In previous years, he served as a Trustee of Roosevelt University and the College of Insurance and Risk Management. He holds an aerospace engineering degree from New York University.

SECTOR — INSURANCE

(AXA602) TWST: How would you describe the current rate environment for your business? In which lines is pricing stronger and in which is it weaker?

Mr. Iordanou: The price environment has improved from, let’s say, a year ago. And the improvement is across the board. Having said that, not every line of business has moved upward with the same velocity as others. So I would say the biggest rate increases are happening in areas that we still believe require more rate movement. That would be primary casualty business and workers’ compensation, excess workers’ comp. Those are the areas that you see double-digit rate increases, but still in order to get to good ROEs on an absolute basis, further movement is required. The rest of the lines, they’re moving up more in the low-single, mid-single digits.

TWST: In March you expanded your underwriting platform in the excess and surplus lines market by starting a binding authority insurance facility that caters to small accounts. Tell us about your reasons for making that shift. How it is playing out so far?

Mr. Iordanou: First, we’ve been developing relationships in the small E&S space for several years. To effectively serve this market, you have to find the proper talent to expand into this sector, so that when we had the opportunity to find the talent and also the marketplace was improving from a rate point of view, we thought it was the right time for us to expand in this sector. So far, even though we have been underwriting this business for only a few months, the volume coming in is even a little higher than what we thought we would achieve in the first year.

TWST: Earlier this year, you announced an agreement to purchase certain assets of PMI and CMG. Tell us about your strategic decision-making process and status of transaction.

Mr. Iordanou: Well, the mortgage insurance space is something that pitches well to our long-term strategy within specialty insurance. We see that the environment since the financial crisis has improved significantly. The underwriting standards have improved significantly, and for that reason we thought it was an opportune time for us to enter the space. We have been underwriting mortgage insurance now for a few years as we have done reinsurance transactions in the U.S., Australia and in Europe. We have quite a bit of knowledge and familiarity with the space. The process is moving as expected — slowly, because we’re dealing with many different constituencies with the GSEs on one hand, the Arizona Insurance Department, the bankruptcy court and the receiver of PMI, and then with CMG we are dealing with CUNA Mutual, which is the 50% joint venture partner in that facility. So it is a bit more complicated than a straight transaction where you are buying something and you only have to negotiate with one party. But the process is moving along pretty much as expected.

TWST: You touched on some regulatory issues to do with that transaction, but more broadly, what’s going on in the regulatory environment for you? What regulatory opportunities and challenges are out there?

Mr. Iordanou: I believe the regulatory environment is stable worldwide, especially with the delay of implementing Solvency II. So from that perspective, we are waiting to see when Solvency II might be implemented, but as a company we are preparing for it. We are ready to adopt it, and we don’t see major obstacles going forward. Having said that, we are also concerned that we might have to satisfy local regulators for our subsidiaries where we operate in different parts of the world, while at the same time we need to satisfy our holding company regulator, and there might be some duplication or conflict in the regulatory oversight. The good news is there are discussions among regulators throughout the world to eliminate some of this duplication.
your business performance that investors should analyze?

Mr. Iordanou: For insurance companies, our ability to grow tangible book value per share is the critical measure, and returns on equity, of course, which aids that process is also very important. And I think if you look at us as a company, we have done extremely well in both categories over the last 11 years since the recapitalization of the company after September 11 of 2001. Our book value per share growth has compounded at 18.1% annually, which is something that we are very proud of.

TWST: Do you think the investment community has a good understanding of Arch Capital’s story and value proposition? And what complexities or nuances about the company can you shed some light on for us?

Mr. Iordanou: It’s an interesting question. I think that our investors know us well and most have been with us for many years. They understand not only our philosophy, but also what we are about. The biggest misunderstanding about Arch is a lot of investors only know us a little bit. We’re more a specialty insurer, with about 60% of our revenue coming from insurance and approximately 40% of our revenue coming from the reinsurance operations. The other area that I think people who have not followed us since the beginning is that our mix of business has changed significantly as we follow lines of business that give us better returns. Today the company is approximately 45% property lines, about 25% longer tail lines, and the rest of it is in medium tail lines of business such as small account professional liability. Back in 2002, we were 80% longer tail lines of business.

The other area that I would point out is that our business over the years has shifted toward small- and medium-size accounts, whereas in the early years we had more of a large account orientation, with more than 50% of our revenue coming from larger accounts.

TWST: What is your five, seven-year vision for Arch Capital?

Mr. Iordanou: We continue to implement the same playbook that we have held over the last 10 years. We like those areas that we have the knowledge or expertise to be a meaningful competitor. And we will grow organically. We have adjusted our playbook either by adding teams of underwriters as we have done with the latest initiative, which is the binding authority business, or by introducing new lines as we have done with the mortgage insurance space. So given a good market, and I think the market is improving, we will have the ability to grow over the next five to seven years and have the potential to organically double the size of the company.

TWST: What are the most significant challenges on the horizon for you for the rest of 2013?

Mr. Iordanou: The challenges are basically the same as you face in every market. For us, since we are a company that depends predominantly on the quality of our personnel, our ability to retain very good personnel is a big priority for us. And we establish the right policies, the right compensation schemes, to be able not only to attract but also to retain exceptional talent.

A second priority is to continue our conservative financial discipline and remain a focused underwriting company. We never focus on topline growth on any one year, even though we like to have above-average growth over the entire cycle. We believe that in the good markets we will grow faster than the average company, and in the not-so-good times we don’t mind shrinking or reducing our writings. I spend quite a bit of my time making sure that we are implementing and executing on those simple principles. So good execution through the industry cycle while attracting and retaining capable underwriters is something we always focus upon. If you do those two things very well, I think you will like the outcome of your activities.

TWST: Thank you. (MES)
COMPANY INTERVIEW

Kemper Corporation (KMPR)

DONALD G. SOUTHWELL is Chairman, President and Chief Executive Officer of Kemper Corporation (formerly Unitrin, Inc.). The Kemper family of insurance companies serves clients in markets across the United States. More than 6 million policyholders have their basic insurance and financial needs met by a network of career agents and independent agents. As one of America’s leading insurance companies, the Kemper family specializes in property, casualty, life, health and accident insurance. With $8 billion in assets, the Kemper family of companies employs about 6,000 associates. Mr. Southwell joined the company in 1996 and has held a variety of operating positions including President and Chief Operating Officer of Unitrin, Inc.; President of the Life and Health Insurance Group; and President, Insurance Operations. He was elected Chief Executive Officer in August 2006 and began serving as Chairman of the board in January 2010. Prior to his Kemper roles, Mr. Southwell spent 22 years with The Prudential and held a number of senior executive positions including President of Pruco Life Insurance Company; President of Prudential Insurance & Financial Services; and Chairman, Prudential Property & Casualty Company. Mr. Southwell is a Fellow of the Society of Actuaries, a Chartered Life Underwriter and a Chartered Property and Casualty Underwriter. He currently serves as the Chairman of the Property Casualty Insurers Association of America. Mr. Southwell is also a member of the board of directors for the Insurance Information Institute and the Executives’ Club of Chicago.

SECTOR — INSURANCE

(AXA603) TWST: Can you start by giving us a brief introduction to Kemper, including a few key highlights from the company’s history and an overview of your business units?

Mr. Southwell: Let me start with an overview of the business units. We are a personal lines property and casualty, and individual life and health insurance company. We serve middle and upper-middle income customers through independent agents and employee agents and other captive agents — so auto, homeowners, life supplemental health insurance. Our history is kind of interesting because we were a collection of acquisitions done by a company called Teledyne many, many years ago, and Teledyne took all these family companies that they had acquired over the years and bundled up everything that had a financial orientation and spun it off in 1990 into our company, which was then called Unitrin. And over the years, since 1990, we have sharpened our focus and paired our holdings and become a more focused company on personal lines in both life and property casualty.

TWST: What is happening for you in the rate environment? Which lines are experiencing the strongest rates? In which lines are rates weaker?

Mr. Southwell: Rates are growing in all lines right now, but the strongest premium growth rate is in homeowners’ insurance. That line has been underpriced by the industry for a number of years, and then increased severe weather that we have seen in the past number of years exacerbated that. So we and the rest of the industry are quite aggressively taking rates in homeowners’ insurance — for example, have double-digit rate increases on top of double-digit rate increases. Auto insurance, on the other hand, is a little more modest, but still there, we have high-single-digit premium rate growth.

TWST: What strategies and philosophies guide your investment activities and how has your portfolio performed over the last few quarters?

Mr. Southwell: Our portfolio has done quite well over the last couple of quarters, given that new money investment rates are still low. We are an income-oriented investor. Certainly on the life side, we need income to support the reserve growth. Having said that, though, total returns are also important, and we’ve got a significant minority percentage of our assets into equities and equity-like investments. So the big challenge — particularly for life insurance, but the challenge for all insurance companies — is, with new money rates so low, like our reinvestment assumption is somewhere around 3%, where do you go for yield? We’ve stayed fully invested. We’ve not stretched our durations too far, nor pressed our credit too far, and fortunately our portfolio yields have held up pretty well, and our total returns have been competitive with our benchmark, which we established really looking at how many other insurance companies invest. We think our total returns have been quite strong.

TWST: Can you tell us about your plans for capital deployment and are you on track to meet your stated goals?

Mr. Southwell: We do have excess capital. And so capital deployment is something we think a lot about. Our excess capital came partly as a result of exiting some businesses that we didn’t want to be in. For example, we had a bank that we decided to exit, and that freed up a couple of hundred million dollars of capital, and then as we’ve been focusing our efforts on improving
margins over growth. We’ve also been able to generate more capital than we’ve needed. So we are in the enviable position of having excess capital, and we’ve given an awful lot a thought about our capital priorities. So I’d like to answer your question really with a long-term/short-term kind of an answer. For the long haul, we think that the top priority for capital is to fund profitable organic growth. We’d also think our capital priority is to acquire businesses that are strategic for us with the kinds of businesses we are already in to make those businesses stronger. And then the third priority for capital is to return it to shareholders in part through a dividend. We have a competitive dividend of about a 3% yield. And so it’s competitive and affordable, and that’s right where we want it. And we’ve also been returning capital through stock buybacks. So you think about those three priorities.

In the short run, we’ve skewed towards the last of those three priorities, because of the fact that we’ve been exiting one business, which reduces our capital needs and frees up capital. And because we are focused on profit improvement over growth, we don’t have the need in 2013, let’s say, to fund organic growth, nor do we think that in 2013 we’ll likely acquire. We’d like to get further operational improvements first. So our short-term emphasis is clearly on stock buybacks. And we’ve been buying back stock and expect to continue buy back stock assuming our stock price stays as compelling as it is.

TWST: How do you attract and retain the most talented employees and reps?

Mr. Southwell: I like to think we have good work, we have high-quality people that others like to work with. So it’s a nice culture and nice environment. The work is good. The work is challenging. Opportunities are many. Pay is certainly competitive, but we want to be competitive on payable. We don’t want to buy people; we want people who are motivated and then well-rewarded. So the money is really the following effect rather than attracting element. So we just have good jobs, good opportunities, and we are a company with a good future. People like to work here.

TWST: What do you believe are your key competitive advantages?

Mr. Southwell: Our competitive advantages on the life side include the fact that we are in a market that very few people serve. And the barriers to entry are significant. So that certainly gives us a competitive advantage. On health insurance, our competitive advantage would be nimbleness. We are at the fringes with supplemental products and filling in some of the holes around health care, and that gives us a competitive advantage — quick to market, strong distribution.

On the property and casualty lines, our competitive advantages are that we partner with our independent agents very well. We offer them a compelling product. Our target market is well-defined. Our product is a premier product in the sense that is good, strong coverage, and we clearly communicate our appetite for what kind of product we want, and agent partners like that. We also have a nonstandard operation. It’s a focus on these particular customer segments, well-communicated to our agent partners and effectively delivered — that makes up our value proposition. And I should say our claims operation is top notch. We constantly get comments about the quality of our claims operation. So claims is a very important function. In that, it’s almost $0.70 on the premium dollar that goes out in claims, and so it’s vital from a financial standpoint. We want to pay every penny we owe and not a penny more. We want to pay it promptly, we want to satisfy our customers. And we do well on all those fronts.

“People see that we are a high-quality company, with excess capital and potential for improvement in P&C leading to earnings enhancements. I see all of that, but one of the things that they sometimes miss is that our diversity of businesses gives us strength. We have a life business that’s not in the same business cycle as our property and casualty business. It has a stable, dependable, cash flow.”

TWST: How would you describe the current regulatory environment? What regulatory risks and/or opportunities are on the horizon for you?

Mr. Southwell: As you know, this is a very heavily regulated business. And some regulatory risk comes around rate approval. In some jurisdictions, you really have to work to get the appropriate amount of rate approved. This regulatory risk around changing the contract terms like with Superstorm Sandy, it didn’t really affect us, but many companies had their contracts in essence voided by the politicians and the regulators by saying they couldn’t invoke the hurricane deductibles. That was a very ambiguous situation. Our policies clearly provide coverage, and we didn’t encounter our problem there, but that kind of attitude towards consumerism regardless of the policy provisions is a regulatory challenge.

TWST: Do you think the investment community has a good understanding of your story? What is a nuance or complexity about the company that you can shed some additional light on for us?

Mr. Southwell: Actually, I do not think the investment community knows us as well as they should. We are a hidden gem, but we’ve been taking steps in recent years. We hired Diana, for example, to head up our investor relations. And a couple of years ago, we didn’t even do earnings calls. We didn’t make it easy for investors to follow us. So we have stepped up our communication efforts, everything from better materials with our quarterly releases to earnings calls, to road shows, to educating analysts and investors about our company. So we won’t be a secret for long, but it’s one of the nuances about our company that sometimes gets missed.

People see that we are a high-quality company, with excess capital and potential for improvement in P&C leading to earnings enhancements. I see all of that, but one of the things that they sometimes miss is that our diversity of businesses gives us strength. We have a life business that’s not in the same business cycle as our property and casualty business. It has a stable, dependable, cash flow. It’s a source of strength. It helps support our dividend. The fact that our businesses are not all on the same cycle is really a benefit. It lets us invest differently; it lets us have a competitive dividend without having to worry about whether we can pay it, and that’s a nuance investors sometimes miss.
TWST: What is your long-term vision for Kemper? How would you like to grow the business over the next five to seven years?

Mr. Southwell: We would definitely like to resume organic growth, and we would also like to grow through acquisitions. We believe that if we are disciplined about our approach to profitability, we’ll have opportunity on both of those fronts. And the most growth opportunities that we have really are on the personal lines property and casualty. Our life business is a wonderful business, but has less growth opportunity than does our property and casualty business. We also have some opportunities on supplemental products and health insurance, but that’s a smaller opportunity. So I’d see plenty of opportunity for us to grow through effectively working with our existing partners and to acquire some additional personal lines business.

TWST: In summary, what would you say are the most compelling reasons an investor would want to take a closer look at Kemper, specifically this year — as opposed to investing a year ago or a year from now?

Mr. Southwell: Specifically, with regard to this year, Kemper represents an opportunity to get in before everybody learns about us, to get in before our operational improvements take full effect and ride the stock up as we improve our performance. It’s also a good time to get in because our capital position allows us to not just to improve operationally, but improve our EPS through buybacks and to improve our EPS through acquisition, even though probably not in 2013, that is a part of our future.

TWST: Thank you. (MES)

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COMPANY INTERVIEW

SECTOR — INSURANCE

(AXA604) TWST: You recently reported your first-quarter results. Can you begin by sharing some highlights from the quarter?

Mr. Bradley: We were happy to end the quarter at 4.2% growth in book value per share, which is one of our primary drivers and measures. We think it’s the clearest metric to shareholder value, particularly given that we report our investment returns on a total return basis. So that’s a good way to include what we can do on the investment side in addition to what we do on the operating side to create shareholder value.

TWST: Which of your business lines are driving growth right now and how are you positioning the company to take advantage of potential opportunities?

Mr. Bradley: The growth drivers for the first quarter were both the U.S. business segment and the reinsurance business segment, growing at over 20% for the quarter year over year. Reinsurance is a little different from our direct business segments, a little more opportunistic. That’s a low fixed cost business, and we allow it to grow and shrink based on the available opportunities, and this was a quarter where we felt there were good growth opportunities given the markets and the lines that we work for the segment. The U.S. insurance segment, which is direct insurance, has seen five or six quarters in a row where we’ve been able to have 20%-plus growth, driven by just a series of new businesses, new lines of businesses and new programs that we’ve been able to launch over the past two or three years. The ones launched three years ago are zipping along and others launched more recently are starting to bear fruit. So we think they’re additive over the years to contribute to that growth.

TWST: How are your premium rates trending across your various business lines and what are the implications of those rate trends for the company?

Mr. Bradley: Our U.S. business segment is actually our leader in rate increases for the year — we averaged almost 6% in the first quarter, with property rates up a little over 10% and casualty rates up a little over 5%. In the international segment, which is mostly our Bermuda-based business, the rates were generally flat, although property rates rose a little more than 4% in the first quarter. So again, the U.S. business, in addition to having real growth, is having nice momentum from the rate growth.

TWST: At the end of last year, you formed a strategic partnership with Aeolus Capital. Tell us about your decision to form that partnership and what success has it created for the company thus far?

Mr. Bradley: It started with a smaller relationship of just being a quota share partner in their reinsurance for the last couple of years. But as we were creating Allied World Financial Services, we were creating an operation that we wanted to selectively invest and be an owner of certain businesses that are ancillary to what we do — in some case service providers, in the Aeolus case an underwriter. So we took a position in a general partnership owning a portion of Aeolus Capital, but then also committing to provide funding for Aeolus Capital over a three-year period. What that translates into is a much higher participation in the business we write. In this case, it’s predicated by the fact that we think that they built a good mouse trap that could serve the collateralized reinsurance market. We think this market in Bermuda is here to stay, and we think Aeolus is out in front with one or two others to be a dominant force in that business. So we wanted to be a part of that both as an owner and as an investor in that fund.

TWST: Going forward, what other kinds of strategic partnerships could make sense for you? Are there any deals in the works that you can share with us?

Mr. Bradley: There are a of couple other similar transactions that we’ve done in the past six months. Aeolus was the biggest one and the last one. Two of the others were buying positions into asset managers, both noncore asset managers, Crescent Capital and MatlinPatterson. It was a similar strategy; we wanted to take an ownership position in an operation that we
Mr. Bradley: As I mentioned, I think the single clearest metric for shareholder value is growth in book value per share. It incorporates all of our gains, if you will, whether from underwriting, expense savings, premiums, investment or tax strategy that flows to the value for the shareholders. That’s probably the highest economic indicator for us. I also look at our economic capital model by line of business, to see where we are making money on an accident-year basis, as well as on a long-term basis, and then allocating our capital towards those businesses where we make money and think we have opportunities to grow.

“We’ve been pretty active repurchasing shares. The board a year ago in July authorized a $500 million share repurchase program, and we’ve been actively using that. We bought back $260 million worth of stock in 2012, and we continue to buy back stock because we think we’re overcapitalized and that Allied World’s stock has been undervalued.”

TWST: What are the most compelling reasons an investor would want to make sure he or she also evaluates?

Mr. Bradley: As I mentioned, I think the single clearest metric for shareholder value is growth in book value per share. It incorporates all of our gains, if you will, whether from underwriting, expense savings, premiums, investment or tax strategy that flows to the value for the shareholders. That’s probably the highest economic indicator for us. I also look at our economic capital model by line of business, to see where we are making money on an accident-year basis, as well as on a long-term basis, and then allocating our capital towards those businesses where we make money and think we have opportunities to grow.

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TWST: What is your capital-management strategy, including share repurchase plans and dividend policy?

Mr. Bradley: We’ve been pretty active repurchasing shares. The board a year ago in July authorized a $500 million share repurchase program, and we’ve been actively using that. We bought back $260 million worth of stock in 2012, and we continue to buy back stock because we think we’re overcapitalized and that Allied World’s stock has been undervalued. It’s even been below book value for most of last year, and at those levels we think that’s a good buy. Actually, just last month the board and the shareholders approved a 33% increase in our dividend from $1.50 per share per year to $2 per year or $0.50 for the quarter. We think that is also a good use of capital, being able to increase the yield to over 2%, even with a rising stock price. We’re trying to pull all the levers of utilizing the strong balance sheet we have and the capital that we generate to return it to the shareholders via dividend and via the share repurchase.

TWST: Can you comment on the overall strength of your balance sheet?

Mr. Bradley: This is a relatively young company, having started just under 12 years ago, so it’s not burdened by the historical legacies of old companies that can have problems come out of the 1950s and 1960s in terms of liabilities. But also the company was started with a strong reserving and underwriting philosophy that has enabled us to build that balance sheet to where it is through consistent reserving. Conservative reserving has allowed us to consistently release reserves from prior years into current accident years. That’s a nice place to be, where your balance sheet builds up to a strong point and is now recognizing reserve releases from business written in 2008 and prior. To date, the business has performed better than we expected with the conservative reserves from those years, and we’re reaping some of that benefit now.

TWST: What are the most compelling reasons an
investor would want to consider investing in Allied World, particularly at this point in time? Why is right now the time to invest?

Mr. Bradley: I’ll say it’s growth and profits, which are kind of the Holy Grail. Our five-year average combined ratio is about 85% indicating the profitability and, as we talked about earlier, the growth rates for the past two years are above market. And that is real growth and it’s growth through rate, and we have been able to do both on a consistent profitable basis. Tying those two things together is kind of what drives our business — to be able to grow and to grow profitably.
SECTOR — INSURANCE

TWST: You released your first-quarter results last week. Can you share some highlights from the quarter with us?

Mr. Williams: We reported an 8% growth in operating revenues, driven by a 13% increase in term life net premium and a 15% increase in investment and savings products sales. Our net operating income per diluted share increased 6% as a result of active capital management. In 2012, we repurchased 9.5 million shares or stock or 15% of outstanding shares for $258 million driving increase in EPS. Our net operating income return on adjusted stockholder equity was 13.3% at the end of the first quarter. This should expand as we begin repurchasing an additional $150 million of shares in second quarter from recently freed-up capital.

TWST: Can you give us an overview of your business lines? In which lines, or even specific products, do you currently see the best opportunities for growth and how are you positioning the company to take advantage of those opportunities?

Mr. Williams: Our focus is on serving the financial needs of the very large middle-income market, which represents about 49% of all U.S. households. We define this market as households with $30,000 to $100,000 in income. Our average customer has $65,000 in household income. We are the middle of the middle market. Our exclusive distribution system of over 90,000 life license representatives and 21,000 mutual fund license representatives gives us a competitive edge in this market. Ninety percent of our life license reps are part-time. They make the majority of the sales, earning supplemental income are managed by the full-time representatives who earn a majority of the income. It is this leverage that allows us to economically write the smaller-average-size transactions of the middle income market when other companies cannot.

We use an educational sales approach and offer simple products appropriate for middle market. When our reps sit down at the kitchen table, they do a financial-needs analysis, which is a simple illustration of a family’s financial picture. Product sales result from this analysis. Our core products are term life and investment and savings products. We sell 10- to 35-year term products appropriate for younger families, who need more income protections due to younger children, higher debt and lower savings, and we distribute third-party mutual funds, segregated funds, variable annuities and fixed indexed stabilities to help families save for retirement and other needs.

We are focused on growing the size of our life license sales force to grow life sales and on expanding our high-return investment savings business. We recently launched fixed indexed annuities and managed account products. In 2012, we issued over 220,000 life policies for the face amount of $68 billion and sold over $4.7 billion in mutual funds and variable annuities.

TWST: Which lines are currently experiencing challenges, and how are you dealing with those challenges?

Mr. Williams: We are focused on growing the size of our life license insurance sales force in order to generate long-term organic growth. Over the last 12 months, we have made changes to incentives, compensation and licensing systems to focus our sales force on growing the number of license representatives. These enhancements led to a 30% increase in the number of new recruits obtaining a life license in 2012, but it did create some downward pressure on recruiting and on life insurance sales. In 2012, we did grow our sales force by 1,200 agents, but feel that we can do better.

One of the beauties of the Primerica business is the economics of our distribution model enable us to make adjustments and manage through periods of adjustment without having a significant impact on short-term earnings. A large block of in force policies generates recurring income regardless of whether life insurance sales are up or down within a given quarter.

TWST: What principles and strategies guide your investment activities and what kind of investment returns have you been able to generate in recent quarters?

Mr. Williams: Due to the nature of our products, we are able to take a conservative approach to managing our $2.1 billion investment portfolio. Selling only profitable term insurance, we do not have the liability matching issues of insurers that sell sensitive products. So we do not need to chase rate. In the first quarter, the average credit rating of our fixed income portfolio was A. Ninety-
five percent of the portfolio was rated investment-grade. The average book yield of investments, excluding cash at quarter end, was 5.28%, and the average duration was 3.9 years. The new money rate on our purchases for the quarter was 2.75%. We had very few new purchases in Primerica Life in the first quarter, as we accumulated cash for the ordinary dividend payment that we will utilize to buy shares back in the second quarter.

**TWST:** How do you attract and retain the best employees and licensed reps?

**Mr. Williams:** First, from the reps’ perspective, our mission is to help families earn more income and become property-protected, debt-free and financially independent. Representatives join our business because our calls-oriented mission resonates with people interested in earning part-time income and is helping their friends and family navigate their financial future. Once someone becomes successful, we have a significant longevity within our sales force — 24,000 of our agents have been with us for more than 10 years, and 8,000 have been with us for more than 20 years. From an employee standpoint, much of the same applies. Our employees identify what the business and its mission. Approximately one-third of our 2,000 employees have been with the company over 15 years.

**TWST:** What is your mid- to long-term vision for Primerica? Where would you like the company to be five to seven years from now?

**Mr. Williams:** We will continue our unwavering commitment to serve the financial needs of Main Street families. We need to grow our life and securities license sales force so that we can serve more families, and we need to expand our product line with products appropriate for our markets or sales force. As the largest independent financial services marketing organization in North America, we are uniquely positioned to profitably sell high volumes of term life and third-party fee-based products to the vast and underserved middle income market. Our objective is to be much larger and helping many more families in the five to seven year time frame.

**TWST:** More imminently, what are your top two or three strategic goals for the remainder of 2013?

**Mr. Williams:** We have our biannual convention coming up next month, with an expected 40,000 representatives attending. The convention is held in the Georgia World Congress Center in the Georgia Dome. Our objective is to have a successful meeting to drive positive momentum in the second half of 2013, which should drive an increase in the size of the life license sales force. And additionally, as I mentioned earlier, we have $150 million of excess capital that we plan to use to repurchase shares to enhance short-term returns.

**TWST:** Do you think the investment community has a good understanding of Primerica’s story and your value proposition? What are some complexities or nuances that people most often tend to misunderstand?

**Mr. Williams:** The most important message we have for the investment community is that Primerica is a distribution company, rather than a traditional life insurance company. I believe they understand this. We traded at a premium of 1.6 times price to book value substantially above the industry. The key points we make are that approximately 40% of our revenue was fee-based versus less than 15% for the industry. We extensively use mortality reinsurance, which provides stable margins, making our term earnings look more like distribution profits. By underwriting only term insurance, we have low investment leverage, which makes us less susceptible to market volatility. This financial profile tied to our unique competitive position in the middle market, which will generate superior returns versus competition, as I said. I really believe the investment community has pretty much understood that message.

**TWST:** What is the most significant business challenge you’re currently grappling with, and what is your plan to deal with that challenge?

**Mr. Williams:** Our business performs better in a thriving economy, and like most companies, we’ve been adversely affected by the economic downturn in the U.S. and Canada and the slow recovery since the last half of 2009. High unemployment and lower family income impact insurance and investment sales. We continue to develop enhancements to our business opportunity, product portfolio and client experience, while actively managing capital in order to drive organic earnings growth and provide meaningful long-term shareholder value.

**TWST:** Thank you. (MES)

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